

On China's Current Economic Policy: Active Fiscal Policy and Prudent Monetary Policy

Jing Ma

School of Economics and Management, Changchun University of Science and Technology

Changchun 130022, China

E-mail: majingdoll@hotmail.com

Wen Fang

School of Economics and Management, Changchun University of Science and Technology

Changchun 130022, China

E-mail: Fangwen8088@163.com

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Abstract

The purpose of this paper is to analyze the active fiscal policy and prudent monetary policy issued by CPC Central Committee Political Bureau in 2011 Economic Work Conference, and their effect on 2011's overall economic situation. Firstly, we elaborate the categories and roles of macroeconomic policy. Secondly, we analyze the meanings of active fiscal policy and prudent monetary policy. Lastly, we describe their effect from the perspectives of price stability, improving people's livelihood and promoting sci-tech progress respectively.

Keywords: Fiscal policy, Monetary policy, Macro-control

1. Preface

The Beijing News reported on December 4th, 2010: "Yesterday, the CPC Central Committee Political Bureau held a meeting to analyze the study of the economic work in 2011, and pointed out the need to implement the active fiscal policy and prudent monetary policy, and to strengthen macro-control target more flexible and more effective." After China's putting forward the monetary policy of "moderately easy" in Nov. 2008 in response to the international financial crisis, it is the first return to the "sound". The fiscal policy in China in 2011 will maintain the tone of the past. We can see that China's central government has been making all efforts to strengthen fiscal policy and to play its effective role in promotion. That is to say, hopefully the Government's macro-control on economic growth can play a more direct and more active role in promoting and stimulating domestic economy. The stability of monetary policy being changed in the new situation shows that the central bank is able to make timely and effective manner to face the situation of an overheated economy, with timely monetary tightening, inhibiting prices and maintaining financial stability. But this does not mean that monetary policy is considerably tightened, but modestly tightened for a steady development.

2. Overview of macroeconomic policy

2.1 Fiscal Policy

Fiscal policy is always defined around the level and composition of government spending (Bruck, 2006). It is made by the Government on fiscal spending and tax policies, which aims to influence macroeconomic activity (Yuan, 2010). Government can adopt budget, tax, treasury, expenditure, financial subsidies and other fiscal policy tools to influence macro-economic operation. From previous experience, increased fiscal spending can boost domestic demand and stimulate economic growth. However, this depends on the structure of fiscal expenditure, because "the overall level of expenditure is negatively correlated with economic growth, and finance productive expenditure is negatively correlated with economic growth" (Guo, 2003). Furthermore, the government needs to consider its contribution to economic growth and the impact on other economic goals when formulating fiscal policies.

2.2 Monetary Policy

Monetary policy refers to government agencies (usually the central bank) making policies on money supply growth rate to influence the macro-economic activities (Yuan, 2010). The website of People's Bank of China issues four main monetary policy tools, i.e. open market operations, cash reserve requirements, central bank loans and interest rate. In most developed countries, open market operations are main monetary policy tool of central bank's throughput of currency, and regulating market liquidity, which helps the central banks and designated securities dealers for foreign exchange trading, so as to achieve monetary policy objectives. Cash Reserve refers to the extraction by financial institutions to ensure customer deposits and capital needs for the liquidation of funds. Financial institutions are required by the central bank to pay the amount of deposit to the reserve, whose ratio of its total deposits is deposit reserve ratio. Through the adjustment of reserve ratio, the central bank controls the supply of credit funds of financial institutions, thereby indirect controlling the money supply. Central bank lending and rediscount loans consist of two major aspects. Interest rate policy is an important part of monetary policy in China. The implementation of monetary policy is one of the principal means. People's Bank of China, according to the needs of monetary policy, can timely apply interest rate instruments, interest rate level and interest rate structure adjustment, thereby affecting demand and supply of social capital to achieve the stated objectives of monetary policy. (Monetary Policy Department, the People's Bank of China, 2005)

3. Signification of “active fiscal policy and prudent monetary policy”

3.1 Active does not mean expansion

As mentioned above, there are expansionary fiscal policy and contraction fiscal policy. However, in recent years Chinese government has been promoting active fiscal policy, so some people mistakenly believe that is expansionary, but actually it is not. “Active” refers to the government's control efforts in the increase; that is to say, the impact on the national economy is more direct and more effective, which stresses the “degree”. And “Expansion” refers to the outward direction of fiscal policy. Through policy Tools, more money will be injected into society and make it function effectively, so it stresses “quantity”. At present, around the popular mind of the residents of economics terms, the terms like GDP, CPI, inflation, and housing bubble and so on, have not been specialized, but are getting popular. In my opinion, whether to make a rough interpretation of terms such as the above mentioned can be defined as one of the standards of illiterate and non-illiterate. This shows that many of the broad and deep economic problems are affecting the daily lives of ordinary people and vital interests. Summing up the above economic phenomenon, we can say that China's economy has overheated currently, therefore the expansionary fiscal policy should not been taken, but an appropriate, effective and tightened approach. It needs modest reductions in fiscal deficits. Of course, the government is facing a challenge on macroeconomic regulation and control, because either the increase of tax rate or the decrease of transfer payments is not what the people expect, which is also incompatible with the goal of improving people's livelihood. Therefore, the active way does not mean tightening; otherwise it is impossible to achieve moderate economic growth. Thus, the Chinese Government must make an issue of revenue and expenditure structure.

3.2 Prudence does not mean contraction

In recent years, especially last year, the term “cash reserve ratio” frequently appears on economic sections in the various media, together with “higher”. From 2006 to 2010, from “slight increase” to “obvious increase”, the sixth increase last year, has been reaching 18.5% of the new historical high (Liu, 2010). From China's Central Bank's current monetary policy, we can see the determination of the Government on the general control of lending and price stability. The work of improving people's livelihood has been the highlight of the government, but the current price index of residents is of low satisfaction, especially in housing price. Although this factor does not rule out speculation, but the excess liquidity is one of the factors boosting inflation. Therefore, the timely and appropriate manner to tighten the money supply will help prevent inflation. However, current monetary policy is regarded as contraction; in fact, prudence does not mean contraction, as the government has to ensure the steady growth of GDP. Blind contraction will lead to the decline in the economic growth data, which is contrary to China's sustained and steady economic growth in the long run. Therefore, the central bank makes adjustments on interest rate to maintain a conservative attitude, and it has not made too much of actions, aiming at stability. 2011 is the first year of 12th Five-Year Plan, and many regions need to increase infrastructure building, so enormous demand for money creates impossibility of tightened monetary policy in 2011 (Gu, 2010).

4. The influence of “active fiscal policy and prudent monetary policy”

4.1 Price stability

Price stability, as the most prominent objectives of macroeconomic policy, is recognized by the majority of economists and the public. The high prices gradually lead to the relative reduction in consumer demand and the people's quality of life. With rigid demand of the prices for daily necessities, the consumers are the main victims. In recent years, prices have gradually rising trend sprawling from the first-tier cities to the second and third tier ones, so that many low and middle income groups find it rather hard to get an apartment, which results in the popular terms such as “snail home” and “ant home”. Therefore, some macroeconomic policies, such as the increase of interest rate of mortgage loan, property tax, abolition of the third loan for housing, raising the deposit reserve ratio and other similar policies will play a role in relieving the situation. So CPI target of 2011 is 4%, one percent lower than current expectations. Therefore, through the implementation of a new round of fiscal policy and monetary policy, it is expected to reduce the CPI index, especially the lower price of basic necessities. But we must also recognize the market economy environment, as well as strong rigidity of many goods, especially housing prices. It is well known that land resources are limited, so the price of land factor can only rise, but not fall under the conditions, as accompanied by a large number of market demand and general market expectations, which make it difficult to control prices. Therefore, only through the role of policy, we hope to mitigate this situation as far as possible, preventing fast rise of price.

4.2 Improve people's livelihood

The increase of the government's macro control, the optimized structure of fiscal expenditure to improve the income of low-income groups, and the promotion of consumer demand for improving the livelihood of the people will play a positive role. In fact, improving people's livelihood and the expansion of domestic demand are consistent with each other. The Government needs to provide more protection for the people's livelihood, so that the residents can increase consumer demand, and improve quality of life, simultaneously stimulating domestic demand, and benefiting the state as well as the people. Meanwhile, we can see that the Government intended to narrow the income gap. Expansionary policies focused on low-income groups, such as the construction of housing projects to increase security efforts, while the tightening of policies tends to high-income groups, such as the proposed increase in tax threshold. This policy direction is consistent with the Western economic policy to great extent.

4.3 Technology promotes economic growth and optimizes industrial structure

Research shows that the economic growth brought by expenditures for scientific research is far higher than that of by investment in physical capital and human capital (Guo, 2003). On the other hand, industrial science and technology bring a rapid growth in knowledge-intensive and technology-intensive industries, along with a rise of high-tech industry in the proportion of the whole industrial system, and a decline of resource industries and low-tech industries in the proportion of the whole industrial system (Yuan, 2005). Technological innovation can create new products, and these new products can meet or induce people to new demands, so technological innovation is the direct effect of changes on industrial structure (Liu, 2006). Therefore, the government's expenditure on science and technology innovation can have a multiplier effect, which can effectively promote economic growth and optimize the industrial structure.

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